

MANAGERIAL COMPENSATION AND THE PROVISION FOR LOAN LOSSES

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This study is an investigation of the relationship of managerial compensation to the provision for loan losses. This study discusses the arguments that have made the relationship between managerial compensation and the provision for loan losses an intuitively appealing concept within the broad agency literature, and based on these arguments, conducts empirical tests aimed at determining whether managerial compensation does relate to the provision for loan losses.

The most current means of studying the income-compensation relationship, the compensation coefficients, makes finding a good understanding of managerial compensation and the provision for loan loss reserves an important goal. The loan loss provision is hypothesized to be a function of loan quality and managerial compensation. If internal and external parties interested in bank performance and reporting better understand the relationship between managerial compensation and the provision for loan losses, more efficient labor contracts can be written and financial performance and reporting should be improved.

The structure of the empirical tests flows from the argument that earnings management represents a cost to shareholders. This argument rests on the assumption that the provision for loan losses specifically plays a central role in managerial compensation at financial institutions. Recent work in agency theory is utilized to construct the setting in which the provision for loan losses is tested for its ability to influence earnings. The empirical model constructed is a

multiple regression equation with the provision for loan loss as the dependent variable, and asset, equity, income and compensation items as independent variables.

The empirical results show that the relationship between managerial compensation and the provision for loan losses is much like the arguments would suggest. Although assets, equity and income are the dominant factors in explaining the provision for loan losses, managerial compensation plays a role in explaining the provision for loan losses.